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## VARIABILITY IN CONSTRUCTION INSURANCE AND ALTERNATIVE INSURANCE SOLUTIONS

### INTRODUCTION

As noted in a recent CMHC study, the insurance market for all types of commercial coverage has hardened over the past few years. Although conditions have started to improve, the insurance market remains “hard” as characterized by rising prices and reductions in capacity to underwrite insurance.

The insurance market for residential construction is contracting, with lower risk tolerance and fewer companies participating in the market. The insurance industry's appetite for insuring residential construction projects has been particularly weak in response to catastrophic fires at construction sites, and the emergence of new risks such as mold and terrorism.

New home builders and renovators obtain information on pre- and post-construction insurance from their insurance brokers. Market effectiveness is determined partly by the extent to which buyers are able to make informed decisions, and partly by the availability of alternatives.

### BACKGROUND

According to the December 2003 study “Insurance in Residential Construction: An Environmental Scan”:

- 81 per cent of builder informants said, currently, increases in insurance costs are higher than increases in overall construction costs;
- 85 per cent of builder informants said some insurance carriers had exited the market in the last three years;
- 12 per cent of builder informants said they have been denied insurance in the last three years; and

- 75 per cent of builder informants reporting insurance denial said they have had to accept lower coverage in order to secure insurance.

Due to concerns over any resultant premium increases, builders generally tend not to claim losses relating to theft and vandalism, although these are insurable. Nearly 16 per cent of builder informants reported unclaimed losses between \$5,000 and \$15,000, viewing them as a cost of doing business.

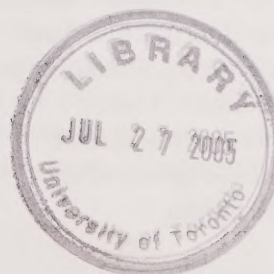
Further:

- 38 per cent of builder informants said more insurance warranties and conditions are increasing construction costs;
- 9 per cent of builder informants said this increase represents about 1-2 per cent of construction costs while 3.1 per cent reported 5-7 per cent; and
- 31 per cent of builder informants said they have increased their deductible limits to offset premium increases.

Examples of costly warranties include watchmen on duty after working hours and site fencing and lighting.

As well, regarding options for alternative forms of coverage:

- 44 per cent of builder respondents cited self-insurance as a developing alternative; and
- 63 per cent also viewed co-insurance/buying pools as alternative forms of coverage.



Of all insurer informants surveyed, the vast majority said:

- the heightened use of warranties would not change; and
- the higher premiums today may remain in the foreseeable future.

*NOTE: wherever the term “builder” is used, it refers to new home builders and renovators.*

## OVERVIEW

This study documents the variability in residential construction insurance, and analyzes alternative residential construction insurance options for builders.

### Variability in Residential Construction Insurance

The availability and affordability of an insurance policy to a builder is based on a number of variables. The more tangible elements include what will be covered and the extent of that coverage; what will be excluded from the policy; what the builder chooses as a deductible amount; and the loss history of the builder. Elements that are less tangible, yet just as relevant, may include the builder's character; loss prevention measures in place; and procedures for the resolution of disputes. These will all factor into the overall cost and likelihood of a builder being able to obtain insurance coverage.

The study defines and describes 27 different insurance policies available to builders. In addition to highlighting some key conditions of the policies, the potential variability between the policies, as well as in the offerings of individual policies is noted. This is designed to increase awareness of what builder policies include and cover.

Some of the key variable elements in insurance policies available to builders include:

- **Perils that are covered.** A peril is an event that causes damage to the builder's property such as fire, lightening, falling objects, vandalism, delay, escape of pollutants, etc. Some policies have built-in peril coverage while others require the inclusion of specific perils at additional cost to the builder.
- **Policy exclusions.** Although defined as such, an “all risks” policy will not actually insure “all risks” or “all property” due to common policy exclusions. These can include the above-mentioned perils, or specific types of property such as money and precious metals, crops and lawns, or vehicles used off premise. These exclusions are often covered under other, specific insurance policies, or can sometimes be added to a policy at additional cost to the builder.
- **Policies tailored to cover risks unique to builders.** As an example, a *Builders Risk Insurance* policy, unlike typical property insurance, is designed specifically for structures in the course of construction and in addition to specific perils and exclusions, covers the materials and supplies to be incorporated into the work. Such insurance can be purchased for a specific project, or on a blanket basis covering all projects undertaken in a specific year by a builder. This last variable element holds for several other policies as well.
- **Who will be using the equipment.** Although equipment such as cranes and bobcats are forms of property, they are not typically covered under standard property insurance if third parties (contractors, sub-contractors, etc.) are using equipment owned by the builder. Insurance specific to contractors, called *Contractors Equipment Floater* must be used in this case.
- **Limits on the amounts able to be claimed by the builder.** This is a key variable element and will directly influence the cost and availability of insurance for a builder. Some policies include financial limits on the amounts to be paid out for specific, specified losses. In some cases, these limits can be increased through other insurance policies and at an additional cost to the builder.
- **Determining the value of the loss.** The policy will stipulate whether the value assessment for a pending claim payment will be made on the basis of the actual costs incurred, or on the replacement value. The difference between these two amounts can be significant.
- **Inclusion of soft costs.** Soft costs are expenses associated with the construction project, but which are not part of the “bricks and mortar” structure. These can include the loss of earnings such as rental income due to project completion delays, real estate and property taxes, interest expense on monies borrowed, etc. Soft costs can add up quickly when projects are delayed. Although there exists a specific policy to cover soft costs, these are often included in other policies as well.
- **Coverage for liabilities assumed through contracts.** Standard liability coverage is typically provided only for those contracts specified in the insurance policy. There are options for including all contracts that could potentially be signed by the builder, as well as setting up a schedule to provide coverage at specific times.
- **Coverage for property in transit.** The variability inherent in such insurance coverage is based on specific property exclusions (money, securities, etc.), acceptable modes of transportation, the countries

covered, and any potential warranties, for example locked vehicle warranties. This type of coverage is available as a stand-alone policy or may be packaged into other insurance offerings.

- **Exclusions in one policy overruling another policy.** As an example, there are instances where a comprehensive policy covering all participants in a specific project (for example, *Wrap-up General Liability*) is nullified by an exclusion in a larger, participant-specific policy (for example, *Commercial General Liability (CGL)*). A wrap-up exclusion in the CGL policy means liability coverage does not extend to parties other than the builder, for example contractors, sub-contractors, etc.
- **Whether potential defence costs are included in the policy limit.** In the event legal representation is required in the resolution of claims disputes, some policies include such legal costs in the policy limit. In other policies, these costs are paid in addition to the policy limit.
- **Coverage limits reduced by purchasing packaged insurance policies.** Several builder insurers have taken steps to combine several policies into one package. However this often reduces the scope and limits permissible under each individual policy. Such packages must be reviewed carefully.

In light of the variability in residential construction insurance offerings, an important consideration is balancing the correct amount of insurance coverage with cost efficiencies.

The above considerations are important both when renewing insurance policies, or when switching insurers. However, it should be noted this report should not replace the personalized advice of an insurance broker.

### Alternative Residential Construction Insurance

In Quebec, members of a professional order may establish an insurance fund as a non-traditional form of self-insurance. A trade association involved in the residential construction industry is currently exploring this option. This is in reaction to rising premiums and a perceived lack of competition between insurance companies.

Other forms of self-insurance analyzed in the research include a *Reciprocal Insurance Exchange Program*. This is a group of organizations who contract with each other to spread the risks and losses inherent in their activities. If one member suffers a loss, all members contribute to the payment of that loss based on a pre-determined formula. In Canada, such programs tend to be set up for not-for-profit organizations such as municipalities, universities, etc.

A *Group Funded Deductible Program* is very similar to the above, although its formation is less formal (i.e.: does not require a contracting process). This type of self-insurance program appeals to groups with a strong relationship between its members. Premium payments made by members are usually held in trust and managed by an insurance broker, or by the group itself. In Canada, such programs have been formed primarily by franchisers, professional associations, and religious groups.

A *Captive Insurance Program* is created by an organization, or group of organizations, to insure some or all of its risks and risk exposures. Captives are legal entities and are generally set-up in locations with established regulatory infrastructures to support their development. Examples of these locations include Bermuda, Barbados, the Cayman Islands and British Columbia, Canada.

There are a variety of captive configurations which make them suitable for corporations of all sizes. There are several examples of captives in the residential construction industry both in Canada and the United States.

One such example is a Canadian builder who created a captive to insure a portion of his insurance requirements. As a result of a strong financial ability, the builder accepts a high deductible from a traditional insurer, but also pays a premium to the non-traditional captive. In addition to retaining some of the profits previously earned by the traditional insurer, the result is a reduction in total insurance costs to the builder.

This is known as a *Single Parent Captive*. It is usually established as a subsidiary of the parent company but is a separate legal entity. This program is ideally suited for medium to large companies that have predictable losses as well as focused risk management and risk-mitigation programs.

A group of mid-sized construction companies in the United States provides an example of a *Group Captive Program*. By pooling together, the entire group reduced their premiums as they were able to accept higher deductibles, as well as increasing their leverage in negotiations with insurance companies. Although such programs are used in other industries (oil and gas, transportation), there are currently no examples in the Canadian residential construction industry.

In a *Group Captive Program*, the premium paid by each member is determined based on the individual risks and risk exposure. In return, the members share in the profits and the losses of the group in proportion to the size of their individual share. Group captives are often formed by trade groups or associations.

There are two other captive program options. The *Rent-a-Captive Program* is organized to insure the risks of unrelated members. This is ideal for an organization too small to form its own captive, or unwilling/unable to join with others in the same industry. The *Protected Cell Captive Program* is similar except that participants are protected from the poor performance of others within the same captive.

It is however, impossible to know how many Canadian organizations take advantage of either *Rent-a-Captive* or *Protected Cell* captives, as the participants are typically private corporations or wealthy individuals. According to a 2001 CFO magazine, there was an estimated 1,000 companies globally participating in both of these programs.

**Project Officers:** Eric Tsang, Bruno Duhamel, Tan Crombie

**Consultant:** Marsh Canada Limited

### Housing Research at CMHC

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Canada Mortgage and Housing Corporation  
700 Montreal Road  
Ottawa, Ontario  
K1A 0P7

Phone: 1 800 668-2642

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